ST 00-18
Tax Type: Sales Tax
Issue: Reasonable Cause on Application of Penalties

STATE OF ILINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	Docket No.
OF THE STATE OF ILLINOIS	)	Registration No.
v.	)	Assessment No.
JOHN DOE'S NURSERY & CRAFTS, INC.	)	John E. White,
Taxpayer	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Monica MacNamara, Hinshaw & Culbertson, appeared for JOHN DOE'S Nursery & Crafts, Inc.; John Alshuler, Special Assistant Attorney General, appeared for the Illinois Department of Revenue

Synopsis:

This matter involves JOHN DOE'S Nursery & Craft, Inc.'s ("JOHN DOE['s]" or "taxpayer['s]") challenge to a late payment penalty assessed by the Illinois Department of Revenue ("Department") regarding taxpayer's failure to make a timely minimum quarter monthly tax payment during the month of May 1999.

Findings of Fact:

1. Because of its average monthly Illinois retailers' occupation tax liability, JOHN DOE'S is required to make minimum quarter monthly tax payments of tax via wire transfer. *See* Taxpayer Ex. 2; 35 **ILCS** 120/3.

2. For the period from January 1998 through the end of June 1999, JOHN DOE'S made all quarter monthly payments in a timely manner but for the payment that was due on April 7, 1999 and the one due on May 7, 1999. Taxpayer Ex. 2.

3. On April 12, 1999, JOHN DOE'S transferred the quarter monthly tax payment that had been due on 4/7/99. Taxpayer Ex. 2. On May 13, 1999, JOHN DOE'S transferred the quarter monthly tax payment that had been due on 5/7/99. *Id*.

4. The Department abated a late payment penalty regarding JOHN DOE'S late quarter monthly payment that was due on April 7, 1999. *See* Hearing Transcript ("Tr.") pp. 5, 38, 55 (arguments of counsel for both sides); Taxpayer Ex. 2.

5. On July 15, 1999, the Department issued Notice of Assessment ("NOA") number XXXXX to Does, which assessed a penalty regarding the quarter monthly payment that had been due on May 7, 1999. Department Ex. 1.

6. Jim Doe ("Jim Doe") is JOHN DOE'S tax manager, and he held that job in 1999. Tr. p. 14.

7. During 1999, Jim Doe supervised two employees, a senior tax accountant and a tax clerk. Tr. p. 14. JOHN DOE'S assigned to its tax clerk the responsibility for making the wire transfers of quarter monthly tax payments to the Department. Tr. p. 16.

8. From approximately June 1998 through the end of April 1999, when he was terminated, JOHN DOE'S tax clerk was Ron Doe ("Ron Doe"). Tr. pp. 17-18, 36. Ron Doe was a temporary employee. Tr. pp. 17, 35.

9. Ron Doe was the tax clerk responsible for making JOHN DOE'S April 7, 1999 quarter monthly tax payment to the Department. Tr. p. 39.

10. Prior to Ron Doe's last day, JOHN DOE'S arranged to hire another temporary tax clerk, Tom Doe ("Tom Doe"). Tr. p. 19.

11. After being referred to JOHN DOE'S for the tax clerk temporary position, Tom Doe told Jim Doe that he had had made wire transfers in Texas, and that he knew how to effect them. Tr. p. 20.

12. Ron Doe trained Tom Doe during the last three days Ron Doe was employed by JOHN DOE'S. Tr. p. 21.

13. Jim Doe gave Tom Doe a copy of a calendar prepared by JOHN DOE'S tax department, which calendar reflected tax return filing and tax payment dates for JOHN DOE'S operations in various states. Tr. p. 24. Jim Doe also gave Tom Doe a copy of a letter from the Department to JOHN DOE'S that lists, for the second quarter of 1999, the dates when JOHN DOE'S Illinois quarter monthly tax payments were due. Tr. p. 25; Taxpayer Ex. 1. That letter stated that, on May 7, 1999, JOHN DOE'S was to make a tax payment to the Department in the amount of $220,246 by electronic funds transfer. Taxpayer Ex. 1.

14. Tom Doe's responsibilities regarding JOHN DOE'S May 7, 1999 quarter monthly payment were to write up the amount of the quarter monthly payment, to get it approved, and to call JOHN DOE'S bank to order that the payment be wired to the Department by the due date. Tr. p. 27.

15. Prior to May 7, 1999, Jim Doe asked Tom Doe if he understood the training Ron Doe gave him. Tr. p. 21. On May 7, 1999, Jim Doe asked Tom Doe whether he made the wire transfers. Tr. pp. 27-28. Tom Doe allegedly replied affirmatively in both instances. Tr. pp. 21, 28.

16. Prior to May 7, 1999, Jim Doe thought Tom Doe performed the functions of tax clerk very well (Tr. p. 23), although no specific instances were offered to support that opinion. Specifically, there was no evidence to show: that Jim Doe ever observed or tested Tom Doe's ability to effect wire transfers; that Tom Doe had successfully completed any wire transfers prior to May 7, 1999; or that Tom Doe had made any payments to others states by wire transfer or by any other method of payment.

17. Jim Doe discovered that JOHN DOE'S had not transferred its May 7, 1999 payment to the Department after Jim Doe had JOHN DOE'S newly hired permanent tax clerk perform what Jim Doe characterized as JOHN DOE'S routine check to ensure that payments ordered to be made via wire transfer had, in fact, been made. Tr. pp. 28-30.

18. Even though Jim Doe said that he discovered that JOHN DOE'S had not timely made its 4/7/99 payment until sometime in May 1999, after he received the Department's penalty assessment for that period, JOHN DOE'S made the payment that was due on 4/7/99 on April 12, 1999. Tr. pp. 39-40.

<u>Conclusions of Law:</u>

Section 3 of the Retailers' Occupation Tax Act provides, in pertinent part:

> *** Beginning October 1, 1995, a taxpayer who has an average monthly tax liability of $50,000 or more shall make all payments required by rules of the Department by electronic funds transfer. ***
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> If the taxpayer's average monthly tax liability to the Department under this Act, the Use Tax Act, the Service Occupation Tax Act, and the Service Use Tax Act, excluding any liability for prepaid sales tax to be remitted in accordance with Section 2d of this Act, was $10,000 or

> more during the preceding 4 complete calendar quarters, he shall file a return with the Department each month by the 20th day of the month next following the month during which such tax liability is incurred and shall make payments to the Department on or before the 7th, 15th, 22nd and last day of the month during which such liability is incurred. … *If any such quarter monthly payment is not paid at the time or in the amount required by this Section, then the taxpayer shall be liable for penalties and interest on the difference between the minimum amount due as a payment and the amount of such quarter monthly payment actually and timely paid, except insofar as the taxpayer has previously made payments for that month to the Department in excess of the minimum payments previously due as provided in this Section*. The Department shall make reasonable rules and regulations to govern the quarter monthly payment amount and quarter monthly payment dates for taxpayers who file on other than a calendar monthly basis.
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35 **ILCS** 120/3 (emphasis added).

Section 3-8 of the Uniform Penalty and Interest Act ("UPIA") provides:

> No penalties if reasonable cause exists. The penalties imposed under the provisions of Sections 3-3, 3-4, and 3-5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department. A taxpayer may protest the imposition of a penalty under Section 3-3, 3-4, or 3-5 on the basis of reasonable cause without protesting the underlying tax liability.

35 **ILCS** 735/3-8. Pursuant to § 3-8 of the UPIA, JOHN DOE'S bears the burden to show that its failure to make a timely quarter monthly payment was due to reasonable cause. *Id*.

JOHN DOE'S argues that it should not be subject to the penalty because of its exemplary payment history and because it exercised ordinary business care and prudence by employing a system of internal controls and procedures that were designed to see to it that JOHN DOE'S timely paid its tax liabilities. *See* Tr. p. 52. A taxpayer's payment history is an appropriate basis for determining whether a taxpayer exercised ordinary business and prudence when attempting to timely pay its proper tax liability. 86 Ill. Admin. Code § 700.400(d). JOHN DOE'S payment history, however, shows that just a month before the period at issue, it had failed to timely make another quarter monthly payment of Illinois tax. Taxpayer Ex. 1. JOHN DOE'S prior payment history was likely the basis for the Department's decision to abate the penalty for its late April payment. *See* Taxpayer Ex. 2; 86 Ill. Admin. Code § 700.400(d). But by the time the month of May 1999 rolled around, JOHN DOE'S history showed that it had failed to timely pay two of its last five quarter monthly tax payments. Taxpayer Ex. 2. JOHN DOE'S payment history, therefore, does not help it here.

If, in fact, the means by which JOHN DOE'S discovered its failure to timely make its May 7, 1999 payment was routinely used every month (*see* Tr. p. 29), then that test must also have been the means by which JOHN DOE'S learned that it had not made its April 7, 1999 payment in a timely manner. But Jim Doe claimed at hearing that he could not recall why Does failed to timely make the April 7, 1999 payment, and he further claimed that he first learned about that prior late payment only after the Department issued a NOA in May, 1999. Tr. pp. 39-40. If Jim Doe' testimony that he first learned of JOHN DOE'S earlier untimely payment in May is true (*see* Tr. pp. 39-40), that means that Ron Doe (or someone else at JOHN DOE'S) was able to run the wire transfer test, discover the error, and then cause to have JOHN DOE'S make the payment late (*see* Taxpayer Ex. 2) — all without Jim Doe becoming aware of those actions. If that is case, then the "back up procedure" JOHN DOE'S employed to test whether its wire payments were being made was insufficient to notify JOHN DOE'S tax manager of the results of that test — a procedure which would hardly constitute an effective system of internal controls. *See* Tr. pp. 29, 53; Taxpayer's Brief, p. 4. Alternatively, it could also mean that the test may not have been as routinely conducted as Jim Doe described.

Regardless, the documentary evidence shows that a month before the payment date at issue, someone at JOHN DOE'S knew that — for whatever reason — the system JOHN DOE'S had in place to ensure compliance with its obligation to make timely payments of its Illinois tax liabilities was not working. Yet the only real evidence JOHN DOE'S offered to show that it exercised ordinary business care and prudence in the face of such notice consists of Jim Doe' mere testimony that he asked a brand new temporary employee if he transferred nearly a quarter of a million dollars to one state's tax department (which may have been, for all the evidence shows, the first wire transfer Tom Doe was supposed to have made for JOHN DOE'S), and his further testimony that he told a different new employee — *after the date Jim Doe knew that Illinois payment was due* — to check to see if Tom Doe really made the transfer he was supposed to make. That evidence does not, in my opinion, show that JOHN DOE'S used ordinary business care and prudence when attempting to timely pay its tax liability.

First, mere testimony is not sufficient to shoulder the taxpayer's burden to show that a statutory penalty should not have been assessed. *See* A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833-34, 527 N.E.2d 1048, 1053 (1st Dist. 1988). Second, the standard of ordinary business care and prudence would seem to suggest that if a business was using a system of internal controls with recently documented flaws, it would proceed to investigate, test and correct that system *before* a future breach would lead to further costs, and not afterward. Here, however, JOHN DOE'S, through its tax manager, knew that Ron Doe was not capable of continuing to perform as JOHN DOE'S tax clerk (*see* Tr. pp. 18-19, 39), yet Ron Doe — who was responsible for JOHN DOE'S late April quarter monthly payment — was given the task of training his temporary replacement. Tr. p. 21, 39. Ron Doe's replacement, was apparently never actually tested to see whether he was able to perform the critical function JOHN DOE'S assigned to him (i.e., arranging for wire transfers of tax payments), and for which JOHN DOE'S was ultimately responsible. *See* Tr. pp. 23, 27-28, 45. I conclude, therefore, that JOHN DOE'S has not satisfied its burden to show that it acted with ordinary business care and prudence when it failed to timely make the May 7, 1999 quarter monthly payment of Illinois retailers' occupation tax.

Conclusion:

For all of the foregoing reasons, I recommend that the Director finalize the penalty assessed for taxpayer's late payment of the tax that was due on May 7, 1999.

6/29/00
Date

Administrative Law Judge